

provide the other services of a secondary market. Associations act as originators, district banks act as poolers, and credit enhancement is provided by the system's agency status. Thus, the sector already has access to national capital markets, and any new secondary market would have to compete with the FCS for a share of this business.

Second, secondary mortgage markets suffer from what is termed "prepayment risk," meaning that bonds backed by mortgages can be redeemed prior to maturity. In contrast, FCS bonds are "non-callable"; once issued, their forced redemption is impossible. Non-callable bonds enable the bond buyer to lock in an interest rate. It should be noted that much of the difficulty facing the FCS today can be traced to the fact that its bondholders locked in high rates of interest during the late 1970s and early 1980s. Again, the difference in the nature of bonds sold by the FCS and the secondary market would be expected to increase the cost of borrowing on a secondary market relative to the FCS. For example, during most of 1986, a period when the financial problems of the FCS were perhaps most severe, short-term FCS bonds carried lower rates of interest than similar bonds issued by the Federal National Mortgage Association (FNMA). Given that the overall risk associated with the housing market is substantially less than in the agriculture sector, one would expect bonds backed by agricultural mortgages to carry higher rates of interest than FNMA and, by implication, FCS bonds. In short, a secondary agricultural mortgage market would be likely to have a higher cost of raising capital than the FCS.

Third, recent or contemplated changes within the FCS would reduce the cost of borrowing from the system. The system is expected to adopt marginal cost pricing (as opposed to the average cost pricing it used in the past) and to provide lower rates to its best customers (instead of one rate for all cooperative members--a practice that the Senate bill would limit). This means that the best borrowers would be able to take advantage of the relatively low nominal rates of interest now available. In addition, if borrower stock purchase requirements were reduced or eliminated, borrowing from the FCS would become cheaper. All of these changes would increase the competitiveness of interest rates on regular Federal Land Bank loans for borrowers who would be likely to qualify for loans financed on the secondary market.

Fourth, because of the relative riskiness of agriculture, the underwriting standards for this market (for example, the maximum percentage financed by the lender) would need to be strict in order to gain investor confidence. But strict standards would limit the volume of business eligible for this market. Small loan volume reduces the efficiency of a secondary market by limiting the potential for pooling risks. An additional implication of strict underwriting standards is that, contrary to popular belief, a secondary market would not directly benefit farmers who are currently experiencing financial stress.

Even if the secondary market enjoyed some success, there are several disadvantages associated with this option. It is probable that a secondary market would work only with a fairly explicit government guarantee attached to its securities. A guarantee would create a contingent liability for the government that could increase expenditures in future years. Furthermore, a government guarantee, whether implicit or explicit, would affect the flow of credit between sectors of the economy. Credit flows would be affected because the guarantee would improve the risk-to-return relationship for agriculture relative to other sectors. As a result, more capital would flow into agriculture than would be merited on strictly economic grounds. While an increased supply of capital is put forward as one of the advantages of a secondary market, it might not be an unalloyed benefit. To the extent that it might lead to overcapitalization (as resulted during the 1970s), the sector's vulnerability to cyclical downturns would be increased (as seen in the 1980s). Finally, it should be noted that lack of loanable funds is not a problem for agricultural lenders at this time. One measure of capital availability is the loan-to-deposit ratio (the closer this value is to one, the tighter are supplies of loanable funds). Currently, most agricultural bankers are reporting record-low or near record-low levels for this ratio (around 0.5), and most would like to increase it substantially (to about 0.65). The problem they are facing is a lack of creditworthy customers seeking loans, not a lack of money to loan. A secondary market cannot address this problem.

#### Secondary Markets in Current Legislation

Both H.R. 3030 and S. 1665 contain language that would create a secondary mortgage market for agriculture. In both bills the

secondary market would be constituted within the FCS, but might not be truly a part of the FCS. For example, the board of directors for the secondary market would be made up of equal numbers of representatives of the FCS and other lenders, with the balance composed of individuals not associated with any lender. In addition, the FCS would provide credit enhancement for the secondary market securities, but joint and several liability would not be shared between the institution managing the secondary market and the rest of the system. It is also not clear how capital earned by the secondary market would be reported in the system's financial statements--specifically, it is not clear what, if any, benefit the system would receive if the secondary market was profitable.

There are a few subtle differences between the two bills with respect to the secondary market provisions. In the Senate bill, the originator may sell 100 percent of a qualified loan to the pooler, or may retain 10 percent of the loan. It is not clear that the House bill allows retention of 10 percent of the loan. If 100 percent of the loan is sold to the pooler, a reserve equal to 10 percent of the original amount of the loan must be established. The reserve can be established by the originator (in which case the reserve is invested in government securities), the pooler, or split between the two. The 10 percent in the reserve or the 10 percent held by the originator must be exhausted before the corporation offering the securities becomes liable to the bondholders. The corporation is authorized to charge a fee for credit enhancement (an unspecified amount in the House bill, up to 0.5 percent in the Senate bill). A portion of the money generated from this fee may be used to create a contingency fund for the corporation. If loan defaults exhaust both the reserve fund created by the originators and/or poolers, and the corporation's contingency fund, the corporation has access to a \$1.5 billion line of credit with the Treasury. Finally, the House bill would authorize the states to impose such reporting requirements on the operation of the secondary market as they deemed necessary.

As noted, the board of directors for the mortgage corporation would have equal representation from the FCS and other lenders, with the balance of the board drawn from people without affiliation with any lender (the Senate bill would have a 15-member board and the House a 13-member board). Among other things, the board of directors helps to establish the standards that must be met to

originate loans for the secondary market and the qualifications for poolers. Both bills authorize the sale of common stock in the corporation to institutions that sell mortgages on the secondary market. They also authorize the mortgage corporation to make assessments on users to pay for its activities.

### Implications of Secondary Mortgage Markets

Implications for the System. The conviction that the secondary market would have limited appeal is buttressed by the following argument. Assume that rather than holding 10 percent of the loan, the originator opts to create a contingency fund in Treasury bills of the same amount. Given that the loan to the farmer is a higher-risk loan than a loan to the government (in the form of a Treasury bill purchase), the rate of return on the reserve would be expected to be less than the return on the farm loan. At the same time, the lender would absorb all losses up to the size of the reserve. This implies that for losses up to the size of the reserve, the lender's return would fall while its risk would remain the same. This trade-off would be offset somewhat if the originator was paid a fee for servicing the loan. However, it can be shown that the size of the servicing fee would have to be unreasonably large if the lender was to be indifferent between the two alternatives.

Of course, for losses greater than the size of the reserve, the lender would lose relatively less if the mortgage was sold on the secondary market. Though the underwriting standards cannot eliminate the possibility of a relatively large default, they would be expected to reduce considerably the probability of such a loss. Clearly a lender could choose to use the secondary market for reasons other than achieving a higher rate of return (to be able to offer a service to a valued customer, as a risk management tool, or to increase the bank's liquidity). However, this analysis indicates that a bank's profitability would not be enhanced by using the secondary market.

In conclusion, a borrower would be likely to find that the rate of interest for a loan sold on the secondary market was greater than a comparable loan financed through the Federal Land Bank. For lenders, the expected return would probably be less for a loan sold on the secondary market than for one retained in the portfolio. Given

these two conclusions, it is unlikely that a secondary market would seriously undermine the financial condition of the FCS.

Budgetary Impacts. For the reasons noted above, an agricultural secondary market would be unlikely to generate a substantial amount of business and hence would not have a major impact on the cost of either bill. This study estimates that the budgetary impact of a secondary market would neither increase nor decrease federal assistance to the FCS available under H.R. 3030 by more than \$50 million over the next five years. The impact on costs under S. 1665 would be even less.

### MINIMUM CAPITAL REQUIREMENTS AND INSURANCE PROGRAMS

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Two policies that have been discussed in connection with assuring the long-term financial viability of the FCS are minimum capital requirements and insurance programs. These policies are, in fact, closely related. For example, minimum capital levels that have to be maintained by a bank are generally based on the relative riskiness of a lender's portfolio. Likewise, the riskiness of the portfolio would be a major factor in determining how much the lender would have to pay as an insurance premium.

The FCS currently has a type of insurance program--the joint and several liability clause. The incentives provided by joint and several liability are rather perverse, however. For example, if a bank were to adopt a risky lending strategy or draw down its capital to low levels, other districts in the system would have to pay to avoid a default on the profligate district's bonds. At the same time, the errant district would not face higher insurance premiums reflecting its riskier behavior.

Premiums for commercial bank insurance, such as that provided by the Federal Deposit Insurance Corporation (FDIC), tend to be based on the types of assets in the portfolio. The advantage of this type of premium calculation is its simplicity of design and administration. Its major deficiency is that the insurance premium is based strictly on the quality of the portfolio in the current period. For example, if insur-

ance premiums increase as the level of nonperforming loans increase, insurance premiums will rise when the bank is least able to afford them. It would be preferable for the insurance premium to be based on the expected payout for the life of each loan in the portfolio. This method would force the bank making a new loan to face the trade-off between riskier but potentially more profitable lending and higher insurance costs on the one hand, and more conservative lending with a lower average return and lower insurance costs on the other. The major drawback of this approach is that it is more difficult to implement since it requires an estimate of future indemnities. Future indemnities are affected by such things as the nature of the activity in which the borrower is engaged, the borrower's managerial decisions, future economic conditions, and the system's future cost of funds. The future course of all these factors would be difficult to predict.

#### Minimum Capital Requirements and Insurance in Current Legislation

The House and Senate bills both provide for minimum capital levels for the FCS. In the House bill, the FCA is instructed to develop minimum capital requirements that are to be phased in over a five-year period. The Senate bill also calls for a five-year phase-in of minimum capital levels defined by the FCA, but during the phase-in period institutions are not penalized for failing to attain the specified levels.

Both bills also establish an insurance fund for the FCS and provide a formula for calculating the maximum premium that an institution can be charged. This formula specifies that insurance premiums will be calculated on the basis of the level of performing and nonaccrual loans. Thus, the insurance fund is very similar to the FDIC program for commercial banks. The only major difference between the insurance programs in the two bills is that the Senate would delay its implementation until 1992. If an FCS institution was unable to meet its obligations to its bondholders, funds in the insurance pool or reserve fund would be the first source of supplemental capital. Only if there were insufficient funds in the insurance pool to cover the default, would the traditional joint and several liability be invoked. If capital was assessed in the name of joint and several liability, this legislation would limit initial assessments to capital that is in excess of the minimum capital levels. If retained earnings in excess of

minimum capital levels were insufficient to cover responsibilities to bondholders, additional assessments could be made.

### Implications of Minimum Capital Requirements and Insurance Programs

Impact on the System. While both of these provisions would increase the cost of operations for the FCS, there are several important advantages to both minimum capital requirements and some form of insurance. One advantage is that both measures would place the FCS on a footing similar to that of commercial banks. Commercial banks purchase deposit insurance through the FDIC or through state insurance boards. In addition, minimum capital standards are also imposed on banks. Thus, the FCS would not be put at a competitive disadvantage to commercial banks by having to establish minimum capital levels and pay insurance premiums (assuming these are both set at levels comparable to those of commercial banks).

Perhaps the most significant long-term effect of these requirements would be that they could provide a means of reducing the federal role in agricultural credit markets. To the extent that minimum capital requirements and an insurance fund would diminish the need for a link between the FCS and the federal government, agency status could be reduced or eliminated. The experience of the savings and loan industry and of the Federal Savings and Loan Insurance Corporation suggests that creation of these safeguards would probably not eliminate governmental involvement in credit institutions. Nevertheless, they should reduce the frequency and magnitude of governmental involvement.

Budgetary Impacts. Because both the minimum capital requirements and the insurance programs are structured differently in the two bills, their budgetary impacts would be quite different.

As noted above, the Senate bill would not penalize institutions for failing to attain minimum capital levels. In addition, there would be no explicit link between receiving assistance and attaining these minimum capital levels, which means that federal funds would not be supplied for the purpose of boosting capital levels. As a result, the cost of this program is minimized. With respect to the insurance fund,

since it would begin only in 1992, its impact on the cost of the bill during the first five years would be minimal. Since the insurance fund would be controlled by a government institution, premiums paid would be scored as receipts in the federal budget. This study estimates that the provisions dealing with minimum capital requirements and the insurance program would reduce the cost of the Senate bill by about \$5 million.

The House bill, in contrast, has no separation between an institution's financial condition and the establishment of minimum capital levels or the payment of insurance premiums. Since banks would be required to attain these capital levels and buy insurance, the government would have to provide financially troubled portions of the system with the capital to do so. This may be wise, given a desire to establish the long-term viability of the system, but in the short term it would be a more expensive approach than the Senate's. The study estimates that the cost of these two factors could increase the cost of the House bill by \$1.8 billion during the next five years.

## CHAPTER IV

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### BORROWERS' RIGHTS

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There is a widely shared view in the Congress and elsewhere that addressing the troubles of the FCS ultimately means addressing the financial problems of its borrowers. While the two FCS assistance bills before the Congress do not directly address farm profitability, both bills place relatively strict limits on the freedom of action of the FCS toward borrowers in financial difficulty. These limits have come to be referred to as borrowers' rights. The borrowers' rights considered in the bills include:

- o Increased access to information;
- o Formalization of the loan restructuring process; and
- o Exemption of some assets from the bankruptcy settlement.

The concern with borrowers' rights stems from a desire to increase the availability of information about the borrowing process, concern that perhaps the FCS has been too quick to foreclose on distressed borrowers, and a desire to reduce the trauma associated with foreclosures when they occur. Two questions arise with respect to this effort. First, has the FCS behaved differently toward its borrowers than have other lenders? Second, if the FCS has behaved differently, is a legislative response appropriate?

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#### FCS BEHAVIOR RELATIVE TO ITS STRESSED BORROWERS

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Probably the key factor in the area of borrowers' rights is the concern about farm foreclosures. There has been an overall increase in foreclosure activity during the past few years, though the precise dimensions of the problem are hard to determine because of a lack of data.

The Department of Agriculture reports that the four major institutional lenders--the FCS, commercial banks, insurance companies, and the Farmers Home Administration--hold approximately eight million acres of farmland.<sup>1/</sup> While the FCS has 53 percent of the agricultural real estate debt accounted for by the four institutional lenders, it holds only 35 percent of the acquired properties (Table 2). Thus, the FCS does not have a disproportionate share of the stock of acquired properties, implying that it has not been extraordinarily quick to foreclose on borrowers.

Another factor that needs to be considered in assessing the performance of the FCS with respect to loan foreclosures is the riskiness of its portfolio. As the riskiness of loans in a lender's portfolio increases, the likelihood of foreclosure should also increase. One measure of the probability of foreclosure in the current year would be the level of delinquent loans in the previous year (since there is a lag between the time a loan becomes delinquent and the time foreclosure is completed). As shown in Table 2, the FCS, with \$5.3 billion, has more than twice as much delinquent debt as commercial banks and nearly three times as much as insurance companies. Only the Farmers Home Administration, which as lender of last resort would be expected to have a riskier portfolio, has more delinquent debt. The higher delinquency level in 1985 is consistent with the larger amounts of acquired property currently in the FCS portfolio.

A second indicator of the riskiness of a lender's portfolio would be the percentage of debt owed by borrowers who have debt-to-asset ratios above 0.7 and a negative cash flow. Again, this measure is lagged a year. Table 2 indicates that borrowers in this financially stressed category held slightly more of the FCS debt than they did of commercial bank debt. This indicates that the percentage of the FCS portfolio at risk is similar to that of commercial banks. As noted above, the FCS holds less acquired property than its market share might suggest. Thus despite having a similar level of risk (as indicated by this measure), the FCS has proportionately less acquired property.

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1. Department of Agriculture, *Agricultural Outlook* (September 1987), p. 20.

In summary, while the FCS has the largest share of acquired farm property, it does not appear to have been more aggressive in using this option than have other major lenders.

### **EQUITY ISSUES ASSOCIATED WITH BORROWERS' RIGHTS**

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Whether or not the FCS has behaved differently toward its borrowers, there is the broader issue of the appropriateness of a legislative response to the problem. Granting special rights to FCS borrowers would raise two sets of equity concerns. First, there is the question of equity across lenders--specifically, that rights granted to FCS borrowers might place the system at a competitive disadvantage vis a vis other agricultural lenders. Further, if borrowers' rights are a good thing, should not all lenders be required to conform to a uniform code of conduct? Why, for example, should a borrower from the FCS be given the right of first refusal on property lost through foreclosure (as would be provided in both the Senate and House bills) while a similar borrower foreclosed upon by an insurance company would not have this option?

The second equity issue concerns borrowers. In some instances, borrowers' rights would convey to a borrower the ability to renegotiate the terms of the loan. Because this ability would be contingent upon being delinquent or at high risk of default, borrowers who remained financially sound would be penalized, at least in a relative sense. This could induce borrowers who are now current on their loans to become delinquent in order to take advantage of these provisions. In contrast, financially stressed borrowers would be rewarded in an absolute sense for what might have been their poor managerial decisions.

### **BORROWERS' RIGHTS IN CURRENT LEGISLATION**

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The two bills have many similarities in their treatment of borrowers' rights, though the House bill goes further than the Senate bill. Both the House and Senate bills would increase the access of borrowers to information. The Senate bill would make FCS lending conform to the standards set by the Truth in Lending Act. For example, it would require that information about interest rates and limits on interest

rate adjustments for variable rate loans be provided to all borrowers. The House bill would give borrowers access to all information about themselves in the possession of the FCS institution.

The main focus of the borrowers' rights provisions of both bills is on loan restructuring. In both, the FCS would be required to provide all borrowers with advance notification of its intention to initiate foreclosure. The Senate bill would require notification 14 days before foreclosure is initiated, the House 75 days. Both bills would require that borrowers be notified of their right to be considered for loan restructuring, that they be given a written explanation if their request is denied, and that they be told of their right to appeal. Both bills would create units to review or assist in implementing loan restructuring programs. In addition, the criteria used in determining eligibility for restructuring are set forth in some detail in the two

TABLE 2. COMPARATIVE DATA ON MAJOR AGRICULTURAL LENDERS

	Real Estate Debt Out- standing 12/31/86 (billions of dollars) <u>a/</u>	Percent of Four Lenders	Acquired Property 2/87 (millions of acres) <u>b/</u>	Percent of Four Lenders
Federal Land Bank	36.2	0.53	2.8	0.35
Commercial Banks	11.3	0.17	1.2	0.15
Insurance Companies	10.4	0.15	2.4	0.30
FmHA	<u>10.3</u>	0.15	<u>1.6</u>	0.20
Total	68.1		8.0	

SOURCE: Compiled by the Congressional Budget Office from the publications indicated.

- a. Department of Agriculture, *Agricultural Finance Situation and Outlook Report* (March 1987).
- b. Department of Agriculture, *Agricultural Outlook* (September 1987).
- c. Farm Credit Corporation of America, *National Credit and Review Standards Monitoring Report: Acquired Property* (December 1986).

pieces of legislation. If foreclosure does occur, both bills would give the original borrower the right of first refusal when the former property is sold. In the House bill the borrower would have up to 60 days to offer to buy or lease the property at current market value, while the Senate bill would allow the borrower only 15 days to submit an offer upon notification of intent to sell. Finally, both bills would foster the creation of state mediation boards that would try to bring borrowers and lenders to some agreement on how to handle their financial difficulties.

The major difference between the two pieces of legislation in the area of borrower rights is H.R. 3030's inclusion of a "homestead" provision. This provision would allow a borrower who has been foreclosed upon to retain possession of the principal residence and up to 10 acres of adjacent land.

TABLE 2. (Continued)

Number of Loans Foreclosed 1986	Delinquency Rates 1985 (billions of dollars) <u>e/</u>	Percent of Debt Owed by Farms with D/A Ratio 0.7 and Negative Cash Flow 1/1/86 <u>a/</u>	Percent of Borrowers with D/A Ratio 0.7 and Negative Cash Flow 1/1/86 <u>a/</u>
3,776 <u>c/</u>	5.3	18.6	11.2
n.a.	2.6	17.1	9.2
1,654 <u>d/</u>	1.8	n.a.	n.a.
89 <u>a/</u>	<u>11.9</u>	45.0	24.4
	21.6		

d. American Council of Life Insurance, *Investment Bulletin* (March 20, 1987).

e. Emanuel Melichar, "Agricultural Finance: Turning the Corner on Problem Farm Debt," *Federal Reserve Bulletin* (July 1987). Data are for entire portfolios of lenders rather than simply real estate loans.

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## IMPLICATIONS OF ADDITIONAL BORROWERS' RIGHTS

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### Implications for the FCS

The purpose of restructuring is to transform a loan that is either not accruing interest at all or not at the rate specified in the loan contract into one that may perform as specified. Restructuring could also be expected to generate goodwill among FCS borrowers. Some borrowers might conceivably prefer a loan from the FCS because of the additional protection offered by the borrowers' rights package.

There are, however, several disadvantages associated with the borrowers' rights provisions. First, to the extent that these rights increase the FCS's cost of doing business, interest rates on loans will rise. For example, one cost of restructuring would be a reduction in FCS capital by the amount of any debt that was written off. Another cost would be the reduced income in future periods from a now-smaller loan, or deferred payments. If the restructured loan failed to perform as expected, additional costs would be generated. All of these costs would make it more difficult for the FCS to compete with lenders who are not required to abide by the borrowers' rights provisions.

A second, and related, disadvantage is that the system might become more selective in its lending if extraordinary costs were associated with loans that became delinquent. While this might be sensible and realistic behavior, the total supply of capital for agriculture would fall. Finally, though restructuring might be beneficial in some cases, it could be a much more expensive alternative for both parties if expectations were not realized. The lender's losses have been discussed above. For the borrower, remaining equity might be lost, either because the value of the collateral might fall or because additional losses could consume the remaining equity.

In sum, inclusion of borrowers' rights provisions in legislation raises a number of short-term and long-term issues. In the short term, many of the borrowers' rights provided by the bills have the effect of retroactively altering the terms of the loan contract. It is not clear that this is fair to the FCS, to borrowers in good standing within the

FCS, or to non-FCS borrowers. In the long term, requiring the FCS to provide rights to its borrowers that other lenders do not provide could reduce the relative competitiveness of the system.

### Budgetary Implications

Enhancing borrowers' access to information would not have major budgetary implications. For the restructuring provisions, CBO's initial cost estimate assumed that even without legislation mandating this approach, bankers would restructure loans if that was the least-cost alternative. However, the right of first refusal, various administrative expenses, and, for the House bill, the homestead provision would increase the amount of federal assistance needed. Over the next five years, the borrowers' rights provisions could be expected to add \$360 million to the House bill and add \$350 million in bond sales and \$65 million in interest expenses to S. 1665.



## CHAPTER V

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### FEDERAL ASSISTANCE FOR THE

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### FARM CREDIT SYSTEM

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The central issue in the debate over the future of the Farm Credit System is the provision of federal assistance. But this raises a number of questions:

- o What is the public interest in the FCS?
- o How much assistance might be needed?
- o What form should the assistance take?
- o When should federal infusions begin?
- o What degree of oversight should accompany the assistance?

### THE PUBLIC INTEREST

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Provision of assistance for the FCS has become a forgone conclusion. Assistance will be provided either through new legislation, or by means of the 1985 Farm Credit Act.<sup>1</sup>

#### Arguments Against Assistance

There are, however, legitimate questions as to the appropriateness of this expenditure. The most basic question is whether the FCS is still needed. The FCS was created by the Congress beginning in 1916 when

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1. The Farm Credit Act of 1985 requires that prior to receiving federal assistance, the Farm Credit Administration must certify that the FCS has fully utilized internal resources in dealing with its financial problems. After the FCA has provided such certification, a line of credit will be established with the Treasury. The amount in the line of credit is subject to appropriations.

the Federal Land Banks were established, in order to address a severe shortage of capital in the agricultural sector. This shortage was largely the result of poorly developed capital markets and agriculture's lack of access to such capital sources as did exist. Given the increasing integration of capital markets (through multibank holding companies, participation agreements between small local banks and regional or money-center banks, and improved communications and information processing capabilities), the institutional imperative for the FCS is less obvious.

A philosophical case against assistance for the FCS could also be built around the argument that this will increase the involvement of the government in allocating credit across sectors. Legislation has conferred "agency status" on the FCS. Agency status grants certain tangible benefits to the FCS (such as exemption from state and local taxes on its bonds, and acceptance of its securities by the Federal Reserve as collateral for advances to banks). Probably more important, its agency status means that investors regard FCS bonds as implicitly backed by the government, even though no explicit governmental guarantee is attached to them. Agency status allows the FCS to raise funds in national capital markets at rates that are only marginally higher than Treasury bill rates. In and of itself, agency status increases the flow of investment capital to the agricultural sector. Providing assistance to the FCS will be seen by investors as tangible proof that their presumption of federal guarantees for FCS bonds was valid. This will perpetuate, if not exacerbate, the role of government in determining the distribution of capital.

Provision of assistance to the FCS also raises equity issues. As shown in Table 3, nearly 400 banks have been declared insolvent and closed during the past three years. The percentage of failed banks classified as agricultural banks, though falling, has been quite high (nearly 60 percent in 1985, roughly half in 1986, and 40 percent through mid-September 1987). Clearly, many non-FCS banks have experienced financial difficulties during the past few years. Why, then, should the FCS receive direct assistance when commercial banks do not?

#### Arguments for Assistance

Proponents of assistance to the FCS generally base their arguments on three factors: the importance of the system for agriculture; past

federal involvement with the FCS; and the potential effect of a FCS failure on national capital markets. The FCS had total assets of \$63.6 billion at the end of the second quarter of 1987 and is the largest institutional lender serving agriculture. FCS dominance in the farm real estate market is even more pronounced: it held nearly 40 percent of farm real estate debt at the close of 1986. It would be very difficult to find institutions able and willing to assume its loans if major parts of the FCS were declared insolvent. The disruptions in the agricultural sector associated with a collapse of the FCS would be considerable, at least in the short term.

As noted above, the FCS has agency status and all of the benefits associated with it. Government involvement does not end with agency status, however. For example, the FCS is restricted by law to lend only to agriculture. Thus, in contrast to other agricultural lenders, its legislative mandate reduces the ability of the FCS to diversify risk. Because it has a dedicated mission, it may merit special treatment by the government.

Finally, some analysts fear that a failure by the FCS would adversely affect national capital markets. The failure of any \$60 billion financial entity would be difficult for capital markets to accommodate. Failure of the FCS might also have a spillover effect on other

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TABLE 3. COMMERCIAL BANK FAILURES

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	1985	1986	1987 <u>a/</u>
Total Commercial Bank Failures	118	136	129
Agricultural Bank Failures <u>b/</u>	68	65	51

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SOURCE: Emanuel Melichar, "Agricultural Finance: Turning the Corner on Problem Farm Debt," *Federal Reserve Bulletin* (July 1987), update of September 18, 1987, Appendix B.

a. Through September 17, 1987.

b. An agricultural bank is one that had an above-average farm loan ratio in December of the year preceding closure.

agency lenders. For example, how would buyers of one of the agency lenders in the housing market react to an FCS failure? Thus far, evidence suggests that the other agency lenders are somewhat insulated from the problems of the FCS. The premium paid on bonds issued by these lenders has remained roughly constant throughout the travails experienced by the FCS. It could be argued, however, that this is because the financial markets discount the possibility that the government would let the FCS fail.

### THE AMOUNT OF ASSISTANCE

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The amount of assistance needed depends not only on general economic factors but also on what might be termed institutional factors, including the degree of cooperation achieved within the system and the details of the legislation providing federal help. For example, in Chapter III it was noted that H.R. 3030 puts an insurance program in place. The premiums that FCS banks have to pay for coverage would increase the total amount of assistance required. In Chapter VI a detailed account of the cost of both bills will be presented. This section presents estimates of the amount needed before any additional legislative requirements are imposed.

This study used the model described in the Appendix to generate an estimate of the amount of assistance needed by the FCS. In the base case it was assumed that assistance would be provided in sufficient amounts to forestall impairment of borrower stock under Generally Accepted Accounting Practices (GAAP). It was also assumed that no additional transfers of capital between districts would occur. Three scenarios were considered. A complete list of the assumptions used in each of the three scenarios is included in the Appendix. Table 4 highlights some of the differences between the three cases.

As shown in Table 5, the assumptions employed in the most likely case would result in total assistance through calendar year 1992 of \$2.8 billion. Under the optimistic assumptions, only \$2.4 billion would be required to avoid borrower stock impairment. If the pessimistic assumptions proved correct, total assistance would be nearly \$3.4 billion.